REPORT #680

TAX SECTION

New York State Bar Association

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January 9, 1991

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Arkansas Best

Dear Commissioner Goldberg:

We write to express our dismay at the announcement on October 2, 1990 by Thomas Hood, Counsellor to the Commissioner, that the Treasury and the Service have suspended indefinitely their project to provide guidance on the taxation of financial hedging transactions in light of Arkansas Best Corp. v. Commissioner, 108 S. Ct. 97 (1988).[1/] Counsellor Hood himself, in his accompanying remarks, recognized the unsatisfactory current state of the law in this area. Accordingly, we recognize that the decision to suspend work on administrative guidance regarding Arkansas Best is, in effect, an acknowledgement of the great difficulty of reaching consensus within Treasury and the Service on some issues, rather than an expression of satisfaction with the current state of the law. Nevertheless, in light of the inappropriate tax results that follow from a literal application of the language of Arkansas Best to financial hedging transactions, we urge that the Treasury and the Internal Revenue Service promptly articulate a coordinated program to resolve any unintended collateral

1/ Daily Tax Report, October 2, 1990 (No. 191) at G-l; Highlights & Documents, October 2, 1990 at 62.

consequences in a manner that is fair to both taxpayers and the fisc. If necessary, such a program should include the recommendation of corrective legislation to be enacted in the upcoming session of Congress.

I. RETROACTIVITY ISSUES.

In Notice 87-68, 1987-2 C.B. 378, the Service suspended its published revenue rulings that rely upon or apply the Corn Products doctrine pending the United States Supreme Court's decision in Arkansas Best. In light of the unforeseeable tax results and extensive litigation likely to follow from a retroactive application of the language of Arkansas Best to financial hedging transactions, we urge that the Service clarify Notice 87-68 by announcing that, although it is now revoking the rulings cited in Notice 87-68, it will exercise its authority under section 7805(b) not to apply Notice 87-68 retroactively to bona fide hedging transactions entered into before April 7, 1988.[2/]

The case for exercising the Treasury's section 7805(b) authority by not giving Notice 87-68 retroactive application is compelling. The tax rules applicable to bona fide business or financial hedging transactions before Arkansas Best were not controversial. For more than three decades between the Supreme Court's decisions in Corn Products Refining Co. v. Commissioner. 350 U.S. 46 (1956), and in Arkansas Best, the application to hedging transactions of the "Corn Products doctrine," as it was then understood, was so well-settled that we are unaware of any litigated tax case from the period (with the possible exception of some foreign currency hedging cases) in which the Government contested a taxpayer's reliance on Corn Products to obtain an ordinary loss deduction for losses sustained in business hedging activities. Academics noted the existence of the Corn

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[2/] The background of the Arkansas Best case and the confusion that the case has created for the taxation of financial hedging transactions, particularly liability hedges and pre-Tax Reform Act of 1986 foreign currency hedges, have been extensively analyzed in legal periodicals. Those analyses can be collectively summarized as recognizing that Arkansas Best's negative impact on financial hedging transactions is real, unintended and the appropriate object of corrective action. See, e.g., Kleinbard and Greenberg, "Business Hedges after Arkansas Best," 43 Tax Law Rev. 393 (1988); McCawley, "Tax Aspects of Interest and Currency Exchange Rate Hedging Transactions," 31 Tax Mgm't Mem. 119 (April 23, 1990); Rudnick and Schenk, "The Tax Treatment of Interest Rate Hedges after Arkansas Best," 6 J. of Tax'n of Investments 22 (1988); Yang, "Impact of Arkansas Best on Some Kinds of Investments Remains Uncertain," 70 J. of Tax'n 106 (February 1989).

Products doctrine,[3] and Congress relied on the existence of the doctrine in drafting section 1256(e) of the Code -- at least in part because of testimony by the then Assistant Secretary of the Treasury as to the application of the Corn Products doctrine to hedging transactions.[4]

During this period, the Internal Revenue Service also promulgated revenue rulings (as well as private letter rulings, technical advice memoranda and General Counsel's memoranda) that relied on the Corn Products doctrine to conclude that taxpayers could obtain ordinary loss deductions from various business hedging transactions.[5] While no published revenue rulings specifically addressed the taxation of liability hedges, a series of private letter rulings and technical advice memoranda relied on Corn Products to conclude that losses sustained in such hedges

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[3] B. Bittker, 2 Federal Taxation of Income. Estates and Gifts. 51.10.3; Surrey, "Definition Problems in Capital Gains Taxation, 69 Harvard Law Rev. 995 (1956); Brown, "The Growing Common Law of Taxation," 34 So. Cal. Law Rev. 235 1961, Javaras, "Corporate Capital Gains and Losses -- The Corn Products Doctrine," 52 Taxes 770 (1974); Miller, "The Unpleasant Taste of Corn Products." 53 So. Cal. Law Rev. 311 (1979).

[4] See Hearings on S. 626 before the Senate Finance Committee, 97th Cong., 1st Sess. 64 (1981) (testimony of Assistant Secretary John E. Chapoton) ("Treasury does not intend for its [straddle] proposal to interfere with normal hedging activities that are carried or as part of an active business. . . . the futures contracts to which we are referring are already treated as ordinary income assets under a decision of the Supreme Court..")

[5] See, e.g., Revenue Ruling 72-179, 1972-1 C.B. 57 (losses on futures contracts used to hedge a manufacturer's cost of raw material "are not in the nature of capital asset transactions," citing Corn Products); Revenue Ruling 78-281, 1978-2 C.B. 204, (foreign currency gain or loss incurred on the repayment of foreign currency borrowing used for business purposes treated as ordinary, albeit without explicitly referring to Corn Products). The Tax Court explicitly acknowledged the role of Corn Products in treating foreign currency hedges as ordinary income or loss items in, among other cases, Wool Distributing Co., 34 T.C. 323 (1960), acq. See also the references to Corn Products in PLR 8127100 (April 13, 1981) (hedges by a U.S. oil company of its exposure to foreign currency fluctuations with respect to foreign tax liability held to be ordinary income or loss), and in TAM 7847004 (August 9, 1978) (hedges of foreign currency exposure attributable to net assets of a foreign branch held to be ordinary income or loss).

were ordinary[6/] -- a result tax advisors found wholly unremarkable.

Before Arkansas Best (and even after Notice 87-68) taxpayers routinely relied on these rulings to avoid timing and character mismatches for their business hedging transactions -- for example, to satisfy the requirement of section 1256(e)(2)(B) that, as a prerequisite to utilizing the section 1256(e) exemption from statutory mark-to-market and straddle rules, both the property or obligation to be hedged and the hedging itself give rise to ordinary gain or loss. Under Arkansas Best, the previous consensus that Corn Products could be used to assure those ordinary income/loss results must now be called into question. If courts ultimately conclude that Arkansas Best means that many transactions entered into as hedges did not in fact generate ordinary income or loss, many taxpayers who in good faith made 1256(e) elections before Arkansas Best arguably did not satisfy the technical requirements for section 1256(e) treatment.

We understand that, in auditing corporate taxpayers, many Internal Revenue agents have applied Arkansas Best to assess deficiencies under the anti-abuse rule of section 1256(f)(1).[7/] This use of section 1256(f)(1) is inappropriate. Any mistake of law that was made in interpreting Corn Products was made, not just by taxpayers, but by the Treasury Department, the Internal Revenue Service and the Congress as well. We cannot believe that Congress ever intended that section 1256(f)(1) -- an anti-abuse rule obviously designed to prevent taxpayers from intentionally gaming the distinction between ordinary income and capital gains -- would be applied in such a fashion.

In our view, the Service has ample authority under section 7805(b) to apply Notice 87-68 prospectively only, and by so doing to administer the tax laws according to the prevailing understanding on which taxpayers relied in structuring pre- Arkansas Best

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6/ See, e.g., TAM 8623003 (February 11, 1986) (futures contracts employed by a savings and loan association to hedge interest rate risk on its short-term borrowings); LTR 8742061 (July 23, 1987) (Treasury futures used by insurance company to hedge interest rate risk on guaranteed investment contracts and similar financial products): LTR 8435054 (May 29, 1984) (Treasury and certificate of deposit futures used by consumer finance company to hedge interest rate risk on its short-term commercial paper).

7/ Section 1256(f)(1) provides that, if a taxpayer makes a section 1256(e) hedging election, and if that transaction in retrospect does not constitute a hedging transaction, any gain on the hedge is treated as ordinary income, but any loss is treated as capital.

hedging transactions. Section 7805(b) authorizes the Service to prescribe the extent to which "any ruling or regulation . . . shall be applied without retroactive effect." The Service has long taken the position that a ruling will not be revoked or modified retroactively, even in the face of a subsequent change in applicable law. (See, e.g., Revenue Procedure 87-1, 1987-1 C.B. 503, § 16.07 at 514.) In order to be consistent with its own policy, therefore, the Service should conclude that section 7805(b) relief should be granted to financial hedging transactions if two questions can be answered in the affirmative: first, whether Arkansas Best represents a change in law, and, second, whether financial hedging transactions are within the scope of the penumbra of Revenue Rulings 72-179, 78-281 and the other authorities to which Notice 87-68 relates. As to the first question, we think that the only fair reading of Arkansas Best is that the case represents a change in law. While we acknowledge that the Supreme Court did not expressly recognize in its opinion that it was making new law, the Arkansas Best opinion in fact follows almost precisely the reasoning of the Second Circuit Court of Appeals in Corn Products [8/] -- reasoning that the Supreme Court in Corn Products quite clearly did not follow. [9/] In light, then, of the well- settled understanding of the "Corn Products doctrine" prior to Arkansas Best, and the fundamental differences in the reasoning adopted by the Arkansas Best Court and that followed by the Corn Products Court, we think that the first prerequisite for the application of section 7805(b) is plainly satisfied.

The remaining question, then, in determining the appropriate application of section 7805(b) in a manner consistent with past Service policy is the reach of the administrative guidance suspended by Notice 87-68. Certainly, taxpayers were entitled to rely on published rulings like Revenue Rulings 72-179 and 78-281. Although the facts of Revenue Ruling 72-179 and Revenue Ruling 78-281 did not specifically involve financial hedging transactions, those rulings were clearly understood within and without the government to extend to all business hedging transactions, an understanding supported by the

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8/ Corn Products Ref. Co. v. Commissioner, 215 F.2d 513, 515 (2d Cir. 1954). Cf. Kleinbard and Greenberg, supra n. 2, at 407-10 (comparing Second Circuit and Supreme Court opinions).

9/ It is difficult, for example, to describe the result of Arkansas Best as anything other than new law in view of the Supreme Court's assertion in Corn Products that "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss . . ." and that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." 350 U.S. at 52.

Service's acquiescence in Wool Distributing and the long series of private letter rulings cited above that applied Corn Products to various types of financial hedges.[10/]

Notice 87-68 itself is consistent with the view that the Service understood that its earlier published revenue rulings relied on a far broader interpretation of the Corn Products doctrine than might be gleaned from the specific facts of Revenue Rulings 72-179 and 78-281. Thus, in Notice 87-68, the Service wrote that it was suspending "its published revenue rulings that rely upon or apply the 'Corn Products doctrine,' . . . . The doctrine . . . has been construed to permit ordinary income (or loss) treatment for certain business-motivated transactions in . . . capital assets." The financial hedging transactions described in this letter plainly fall within the scope of the Service's view of the Corn Products doctrine, as set out in Notice 87-68.

Indeed, it is by no means certain that, notwithstanding the language of the Arkansas Best opinion, the Supreme Court necessarily would reach the same conclusion in cases involving transactions of the type described in the rulings cited in notice 87-68 or, at least, in situations falling under section 1256(e). We doubt that, when it decided Arkansas Best, the Supreme Court was aware of those rulings or the legislative history of section 1256(e). Thus, it is conceivable that, when made aware of this administrative and legislative background, the Court would limit the expansive interpretation of section 1221 that it articulated in Arkansas Best.

Moreover, the section 7805(b) relief proposed herein would be similar to the relief which could be obtained judicially under the precedents that would permit the Supreme Court itself to rule that the application of Arkansas Best to financial hedging transactions should be applied prospectively only. In Chevron Oil Co. v. Huson, 404 U.S. 97 (1971), a case involving the appropriate statute of limitations under the Outer Continental Shelf Lands Act, the Supreme Court held that a court decision should be given nonretroactive application where it establishes a new principle of law by overruling past precedents

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10/ A previous Chief Counsel of the Service has stated that the Commissioner's Section 7805(b) authority may be exercised to avoid retroactive revocation of an acquiescence, "where the acquiescence to be revoked is one of broad general application and of long standing which has been consistently relied upon by the National Office and District Directors in issuing rulings and determination letters." Rogovin, "The Four R's: Regulations, Rulings, Reliance and Retroactivity," 43 Taxes 756, 773 (1965). Rogovin cited Revenue Ruling 65-259, 1965-2 C.B. 174, as an example of such action.

on which litigants have relied, where prospective application of the new rule will not retard its operation and where the decision would produce inequitable results if applied retroactively. This doctrine had been held to be controlling in a variety of cases.[11/]

As a matter of sound tax administration, therefore, the unforeseeable misapplication of section 1256(f)(1) could be avoided, and other unfairness resulting from a retroactive application of Notice 87-68 alleviated, if the Service invoked its section 7805(b) authority to apply Notice 87-68 prospectively only. We anticipate that the Service would accomplish this result by issuing a new notice that revoked the rulings cited in Notice 87-68 and further stated that the Service would no longer apply the Corn Products doctrine, as summarized in Notice 87-68, in each case with the prospective effective date, and subject to the special procedures, described below. This result would be consistent with the history of the Corn Products doctrine summarized above and the Service's explicit acknowledgement in Notice 87-68 of its own broad interpretation of the scope of the Corn Products doctrine. This use of section 7805(b) also would be consistent with the Service's policy of not reversing rulings retroactively, because that action would preserve the principles underlying the two published rulings and the Service's acquiescence in Wool Distributing, as those underlying principles were then commonly understood. Finally, this approach would be consistent with the manner in which the Service has applied section 7805(b) when it has reversed outstanding published rulings or regulations.

At its narrowest, section 7805(b) relief could be offered to taxpayers that actually made section 1256(e) elections before Notice 87-68 appeared. This would at least restore section 1256(f)(1) to its proper role as a modest anti-abuse rule.

11/ American Trucking Assns. v. Smith, 110 S.Ct. 2323 (1990) (doctrine held applicable in case involving application of commerce clause to highway use taxes); Northern Pipeline Co. v. Marathon Pipeline Co., 458 U.S. 50 (1982) (decision that provision of 1978 Bankruptcy Act was unconstitutional applied prospectively only); Hanover Shoe Inc. v. United Shoe Machinery Corp., 377 F.2d 776 (3d Cir. 1967, reversed on this issue. 392 U.S. 481, 496 (1968) court found no change in the law); Zweibon v. Mitchell. 606 F.2d 1172 (D.C. Cir. 1979) (Chevron Oil standard held inapplicable because decision relating to wire taps could have been anticipated) For a general discussion of the non-retroactive application of judicial decisions, see Calabresi, A Common Law for the Age of Statutes. Harvard University Press (1982), 279-282. See also, James B. Beam Distilling Co. v. State of Georgia, 382 S.E.2d 95 (1989) where the scope of the rule in a state tax case is currently being reviewed by the Supreme Court.

A narrow application of section 7805(b) would fail, however, to cover many taxpayers that did not need to make section 1256(e) elections (because, for example, their hedges involved neither "straddles" in the section 1092 sense nor "section 1256 contracts"), but who nonetheless relied on Corn Products to determine the character of their hedging gains or losses.

One straightforward means of targeting section 7805(b) relief from the application of Notice 87-68 to bona fide hedging transactions would be to provide such relief to transactions described in section 1256(e)(2)(A). Under this approach, Notice 87-68 would not apply retroactively to transactions entered into by the taxpayer in the normal course of its trade or business to reduce its exposure to price, currency or interest rate volatility -- in other words, precisely that category of transactions that Congress and the Treasury thought would result in ordinary income or loss when section 1256(e) was drafted, and that the Service thought were covered by Revenue Rulings 7 2-179 and 78-281. By referring to section 1256(e)(2)(A) and not sections 1256(e)(2)(B) or (C), this proposal would avoid the circularity problem of section 1256(e)(2)(B) (which effectively requires the Corn Products doctrine to operate as Congress expected), and would restore mandatory ordinary income/loss treatment for transactions that are hedges in a commercial sense, without regard to whether a section 1256(e) election was made for timing purposes.

One concern that might be raised by this proposal to provide section 7805(b) relief from the application of Notice 87-68 to transactions described in section 1256(e)(2)(A) is that such an approach might leave the fisc vulnerable to "cherry- picking" by taxpayers: that is, taxpayers would rely on Arkansas Best to treat hedging gains as capital gain, and on the notice granting section 7805(b) relief to treat hedging losses as ordinary loss. We think that, in practice, this risk is overstated.[12/] More to the point, however, if Treasury is concerned about "cherry picking" issues, the most straightforward solution to the problem would be to require

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12/ At least in the case of liability hedges, the gains in question would have to be attributable to the hedge transaction, rather than to the position being hedged, since in all such cases covered by this letter the latter would constitute an ordinary income/loss position. In addition, in many cases those gains would constitute short-term capital gain, both because of the term for which the hedge transactions were held open, and by operation of the straddle rules of section 1092. Accordingly, most taxpayers would obtain no benefit from recharacterizing any gains as capital gain, unless they had available otherwise unusable capital losses.

taxpayers to enter into closing agreements agreeing to treat hedging gains and losses consistently in order to claim the benefits of section 7805(b). Since section 7805(b) by its terms permits the Secretary of the Treasury to prescribe “the extent ... to which”, it appears to us that Treasury would have the authority to impose a condition of consistency on taxpayers seeking relief from retroactivity. Moreover, closing agreements and similar undertakings have in recent years been widely used by the Internal Revenue Service in its dealings with taxpayers -- for example, in the section 367 area. We are not aware of any administrative problems in these other areas that would argue against using closing agreements to ensure consistency in this case.

Finally, we suggest that the most appropriate cut-off date for such administrative relief would be April 7, 1988 -- 30 days after the date the Arkansas Best decision was handed down. In our view, neither Notice 87-68 (which suspended the application of all Corn Products doctrine rulings, including rulings like Revenue Ruling 58-40, 1958-1 C.B. 275, which arguably supported the taxpayer's position in Arkansas Best) nor the facts of the Arkansas Best case itself (which facts had nothing to do with hedging) fairly put taxpayers on notice that the tax law of hedging transactions would be rewritten by the reasoning of the Arkansas Best court.

While it is true that Notice 87-68 indicated that the government intended to argue before the Supreme Court “that Congress statutorily defined a capital asset to include all property other than property specifically excepted by section 1221,” nothing in Notice 87-68 suggested that the government's briefs in Arkansas Best would fail to inform the Court of the Service's own reliance on Corn Products in Revenue Rulings 72-119 and 78-281 (as well, presumably, in its acquiescence in Wool Distributing), or Congress' reliance on Corn Products in drafting section 1256(e). Moreover, there was good reason for taxpayers engaged in straightforward business hedging transactions -- which transactions had been accorded ordinary income/loss results long before Corn Products was litigated[13/] -- to believe that the reasoning of the Arkansas Best decision would be limited to the facts before the Court, and therefore would not affect bona fide hedging transactions.

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[13] G.C.M. 17322, XV-2 C.B. 151 (1936); Ben Grote, 41 B.T.A. 247 (1940), nonacq.

II. PROSPECTIVE SOLUTIONS.

As has been widely noted, the most difficult issues in the prospective application of Arkansas Best relate to U.S. dollar liability hedging. We recognize that the prospective issues do not raise the same fairness and reliance concerns as, for example, the plight of taxpayers that might be retroactively affected by Arkansas Best and section 1256(f)(1) for prior years. We also acknowledge that prospective administrative pronouncements concerning the tax law of liability hedging raise difficult issues of statutory authority. Nevertheless, we think that as a matter of economic policy the tax law should not discourage transactions that reduce taxpayers' exposure to interest rate volatility by subjecting such transactions to potential ordinary income/capital loss mismatches.

The Tax Section has no specific view at this time as to whether (or how) Treasury and the Service prospectively can rationalize the tax law of liability hedging on a purely administrative basis. It may be necessary to address the issue through an amendment to the Internal Revenue Code.[14/]

We would be pleased to work with you in any way you think helpful to resolve a group of problems which have become of very serious concern to a large number of taxpayers.

Very truly yours,

Arthur A. Feder
Chair

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14/ Such legislation itself could be retroactive. See e.g. the retroactive legislation enacted in 1939 (now contained in Section 357 of the Code) that reversed the unexpected holding in United States v. Hendler, 303 U.S. 564 (1938) that the assumption of liabilities results in the recognition of gain in what otherwise are tax free exchanges.

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